IT 96-1
Tax Type: INCOME TAX
Issue: Business/Non-Business (General)

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE)		
OF THE STATE OF ILLINOIS)		
	)	Docket No.
v.	)	FEIN:
	)	
TAXPAYER,	)	Harve D. Tucker,
Taxpayer	)	Administrative Law Judge

RECOMMENDATION FOR DISPOSITION

Appearances:

ATTORNEY, for TAXPAYER; Thomas P. Jacobsen, Special Assistant Attorney General, for the Illinois Department of Revenue.

Synopsis:

This matter comes on for hearing pursuant to the Taxpayer's timely protest to the Notice of Deficiency dated December 12, 1991, for income tax and penalties. At issue is whether the capital gain realized upon the sale of the Taxpayer's common stock interest in CORPORATION is business income apportionable to Illinois. Following the hearing, submission of all evidence and a review of the record, it is recommended that this matter be resolved in favor of the Department of Revenue.

Findings of Fact:

General Background and Procedural

1. TAXPAYER A and TAXPAYER B formed CORPORATION on November 1, 1983, when TAXPAYER A and TAXPAYER B each contributed their business divisions engaged in the manufacturing and marketing of polypropylene resins to CORPORATION. TAXPAYER A and TAXPAYER B each owned 50% of the outstanding common stock of CORPORATION and were the only shareholders. Stip.3

2. On February 12, 1987, CORPORATION issued 22.6% of its common stock in a public offering, at an issue price of $28.00 per share. Thereafter, CORPORATION became a public company whose common stock was listed on the New York Stock Exchange. After the public offering and sale of stock, TAXPAYER A and TAXPAYER B each owned 38.7 % of the outstanding stock of CORPORATION. Stip.3

3. On September 25, 1987, TAXPAYER A sold all of its 38.7% common stock interest in CORPORATION to TAXPAYER B — a total of 25 million shares at $59.50 per share for a total of $1,486,500,000. Stip.2

4. TAXPAYER A filed a timely 1987 Illinois Corporation Income and Replacement Tax Return. The net capital gain on the sale of the CORPORATION stock for income tax purposes was $1,338,501,966. The gain from the sale was reported as nonbusiness income on the return. Stip.2, Stip.4, Ex.3

5. The Department issued a Notice of Deficiency on December 12, 1991. One adjustment made in the Notice of Deficiency was to disallow the entire subtraction for nonbusiness income reported by TAXPAYER A with respect to the sale of the CORPORATION stock. Stip.5, Ex.1

6. On February 3, 1992, TAXPAYER A filed a timely protest to the Department's Notice of Deficiency, protesting only this issue. Stip.6, Ex.2

Operations of TAXPAYER A

7. TAXPAYER A was in the business of manufacturing and selling a broad line of over 1,000 natural and synthetic products and materials worldwide. Stip.9, Ex.15-22

8. TAXPAYER A had its principal place of business in Delaware. TAXPAYER A' business operations and assets were managed, directed and controlled from its corporate headquarters in Delaware. Stip.8

9. TAXPAYER A' principal business activity in Illinois was the sale of industrial chemicals to customers in Illinois. Stip.16

10. During 1983, TAXPAYER A was organized into three business divisions, each of which contained several business centers:

TAXPAYER A Company included —

Stip. 10, Ex.15-20

11. Prior to November 1, 1983, TAXPAYER A was engaged in the business of manufacturing and marketing polypropylene resins through the CENTER. It owned and operated polypropylene manufacturing facilities in the United States, Canada and Belgium. Stip.11

12. The sale of polypropylene resins manufactured by the CENTER to TAXPAYER A' customers amounted to $429 million in 1981 (plus $88 million utilized by TAXPAYER A), $416 million in 1982 and $363 million for the 10 months of 1983 prior to the contribution of the CENTER to CORPORATION. Stip.13

13. Subsequent to the transfer of TAXPAYER A' polypropylene resin manufacturing and marketing business to CORPORATION on November 1, 1983, TAXPAYER A no longer manufactured polypropylene resins. After that date, TAXPAYER A purchased polypropylene from CORPORATION and other suppliers. Stip.15

14. TAXPAYER A did not own or operate any manufacturing facilities within Illinois. Neither TAXPAYER A prior to November 1, 1983, nor CORPORATION on or after November 1, 1983, owned or operated any polypropylene manufacturing facilities within Illinois. Stip.18

Formation of CORPORATION

15. In and prior to 1983, the management of TAXPAYER A considered the disposition or repositioning of its polypropylene resin manufacturing division, the CENTER. Stip.19

16. In 1981, TAXPAYER B had developed, together with INDUSTRY, an advanced catalyst-based technology for the manufacture of polypropylene resins. The TAXPAYER B technology enabled the manufacture of polypropylene with a wider range of properties and a lower cost than the processes previously used by TAXPAYER A. Stip.20; Ex.11, p.11

17. In early 1983, TAXPAYER A and TAXPAYER B undertook the negotiation of the combination of their polypropylene businesses into a new company, to be owned 50% each by TAXPAYER A and TAXPAYER B. Stip.21

18. On June 28, 1983, TAXPAYER A and TAXPAYER B executed a Joint Venture Agreement, governing the contributions of their respective polypropylene manufacturing businesses to CORPORATION. Stip.23; Ex.4

19. Pursuant to the Joint Venture Agreement, CORPORATION was incorporated as a Delaware corporation. On November 1, 1983, TAXPAYER A contributed all of the assets related to its CENTER to CORPORATION in exchange for 50% of the common stock of CORPORATION. At the same time, TAXPAYER B transferred to CORPORATION all of the assets related to its polypropylene resin manufacturing business, in exchange for the other 50% of the common stock of CORPORATION.

20. The assets transferred to CORPORATION included all of TAXPAYER A' polypropylene resin manufacturing assets, technology and business, including its plants in the United States, Canada and Belgium; trademarks, service marks, trade names, brand names, slogans and product designs which related to the production, sale, and use of polypropylene; all of TAXPAYER A' patents, pending patent applications, copyrights, technologies and technical information used on its polypropylene manufacturing business; inventories of finished polypropylene products, work in progress and raw materials; and accounts receivable generated by the polypropylene business. Stip.26

21. Also on November 1, 1983, all employees of TAXPAYER A' CENTER — including plant personnel, research and technology staff, and administrative and support staffs — terminated their employment at TAXPAYER A and accepted employment with CORPORATION. All personnel involved in TAXPAYER A' polypropylene operations prior to the 1983 transfer were hired by CORPORATION, and none were ever reemployed by TAXPAYER A nor were employed simultaneously by TAXPAYER A and CORPORATION.. Stip.27; Stip.31

22. After its transfer of assets to CORPORATION on November 1, 1983, TAXPAYER A no longer had any facilities, personnel or technology to engage in the business of manufacturing and marketing polypropylene resins. Stip.28

Business Operations of CORPORATION

23. After the transfer of assets by TAXPAYER A and TAXPAYER B to CORPORATION on November 1, 1983, CORPORATION engaged in the business of manufacturing and marketing polypropylene products and in the licensing of its technology to other manufacturers of polypropylene resins. Stip.30

24. At all times on and after November 1, 1983, CORPORATION employed and maintained its own manufacturing, research and administrative personnel. Stip.31

25. CORPORATION established its own banking relationships and lines of credit with major money center commercial banks as of the date of its formation. CORPORATION's banking relationships and lines of credit were supported solely by the CORPORATION business. Neither TAXPAYER A nor TAXPAYER B guaranteed or otherwise assisted CORPORATION in obtaining financing. There were no intercompany loans made from either TAXPAYER A or TAXPAYER B to CORPORATION. The Shareholders Agreement provided that borrowings by CORPORATION would be provided from third party lenders to the extent possible, but that support for CORPORATION borrowings would be provided by TAXPAYER A and TAXPAYER B on a prorata basis if third party borrowings were not possible. Neither TAXPAYER A nor TAXPAYER B provided any credit support or loans to CORPORATION. Stip.32

26. There was no use by CORPORATION of the manufacturing facilities of TAXPAYER A or TAXPAYER B. There was no use by TAXPAYER A or TAXPAYER B of CORPORATION's manufacturing facilities. Stip.33

27. There was no centralized or joint purchasing of supplies or raw materials by TAXPAYER A and CORPORATION. Stip.34

28. There was no joint marketing program by TAXPAYER A and CORPORATION. There was no joint ownership or use by TAXPAYER A and CORPORATION of any trademarks, service marks, trade names, logos or product designs. Stip.35

28. No products or services were jointly developed or sold by TAXPAYER A and CORPORATION. Stip.36

29. CORPORATION spent $237 million on capital improvements during its first three fiscal years, and financed these investments out of cash flow from its operations. Stip.39

Intercompany Transactions between TAXPAYER A and CORPORATION

30. After the formation of CORPORATION, TAXPAYER A continued to use polypropylene resins as a primary raw material. It purchased polypropylene from CORPORATION and other polypropylene manufacturers. Stip.40

31. TAXPAYER A' purchases from CORPORATION were pursuant to a Supply Agreement dated November 1, 1983. TAXPAYER A was obligated to purchase 85% of its polypropylene supply requirements from CORPORATION prior to 1987 and 80% thereafter. In

these years, TAXPAYER A also purchased polypropylene resins from major producers of polypropylene. Stip.41, Stip.42; Ex.7, Ex.11, Ex.24.

32. Sales of polypropylene resins from CORPORATION to TAXPAYER A are set forth as follows:

Fiscal Year	CORPORATION Sales to TAXPAYER A	Total CORPORATION Sales (% to TAXPAYER A)	Total TAXPAYER A Revenues (% CORPORATION)
1984	$117.2	$915 (12.8%)	$2,571 (4.6%)
1985	$117.2	$910 (12.9%)	$2,587 (4.5%)
1986	$121.6	$981 (12.4%)	$2,615 (4.7%)
1987	$146.0	$1,165 (12.5%)	$2,693 (5.4%)
1988	$133.4	$1,711 (7.8%)	$2,802 (4.8%)

Stip.43

33. Certain general and administrative services — including legal, tax return preparation, internal audit and payroll services — were provided by TAXPAYER A to CORPORATION pursuant to the Corporate Auxiliary Services Contract. The amounts paid by CORPORATION pursuant to this contract totalled $9.9 million for CORPORATION's fiscal year ending October 31, 1984; $9.9 million for 1985; $9.4 million for 1986. Stip.44; Ex.8; Ex.11

34. After the formation of CORPORATION and through 1987, TAXPAYER A paid CORPORATION to provide those research and development, safety and operations services, and certain utilities which had previously been provided by TAXPAYER A' CENTER to TAXPAYER A' other business centers. Prior to the formation of CORPORATION, services such as accounting, billing services and other bookkeeping services, had been provided by certain TAXPAYER A facilities to other nearby facilities. After the transfer of TAXPAYER A' assets to CORPORATION on November 1, 1983, certain of these services continued. The amounts paid by TAXPAYER A to

CORPORATION pursuant to the Services Contract totalled $3.5 million for CORPORATION's fiscal year ending October 31, 1984; $2.8 million for 1985; and #3.5 million for 1986. Stip.45; Ex.9; Ex.11

35. For the years 1983 through 1987, TAXPAYER A rented office space to CORPORATION in the TAXPAYER A Plaza in Delaware. The property was rented under the terms of the Corporate Auxiliary Service Agreement. Stip.46; Ex.8

Management of CORPORATION and Common Directors with TAXPAYER A

36. At the time of the initial formation of CORPORATION, both TAXPAYER A and TAXPAYER B were entitled to appoint 3 directors to CORPORATION's 6 member Board of Directors. Except for the 3 individuals appointed by TAXPAYER A to the CORPORATION board and who served CORPORATION solely in their capacities as directors, there were no common officers or employees between TAXPAYER A and CORPORATION. Stip.54

37. In anticipation of CORPORATION's initial public offering on February 12, 1987, its Board of Directors was expanded to 9 members. Thereafter, TAXPAYER A continued to have the right to appoint 3 members of the Board of Directors. Stip.55

38. The Shareholders Agreement provided for the selection of CORPORATION's officers in a manner reflecting the equal ownership of CORPORATION by TAXPAYER A and TAXPAYER B. TAXPAYER A selected CORPORATION's President, Vice President for North American Operations, Vice President for Administration and General Counsel, Vice President of Finance and Chief Financial Officer, and Controller. TAXPAYER B selected CORPORATION's Vice President for Technology, Vice President for European Operations, Vice President of Business Management, and Treasurer. Stip.56; Ex.5

39. The Shareholders Agreement provided that key officials of CORPORATION would be selected by CORPORATION's president following consultation with TAXPAYER A and TAXPAYER B, drawing from the pool of executive talent associated with the business to be contributed or, if necessary, from outside of TAXPAYER A and TAXPAYER B. Stip.57; Ex.5

40. The Shareholders Agreement provided that TAXPAYER B would nominate the Vice Presidents for Business Management and for Technology and that TAXPAYER A would nominate CORPORATION's Vice Presidents for Financial Accounting and Administration. The head of European operations and a key employee in CORPORATION's financial area would be nominated by TAXPAYER B and the head of North American operations would be nominated by TAXPAYER A. Stip.58; Ex.5

41. The Shareholders Agreement further provided that key officials of CORPORATION would be selected by CORPORATION's president. Employees were to be selected on the basis of merit and no employee of CORPORATION would, at the same time, be employed by or receive compensation from TAXPAYER A or TAXPAYER B or any of their subsidiaries other than pension or retirement benefits or deferred compensation arrangements. Stip.59; Ex. 5

42. During 1983-1987, TAXPAYER A had 17, 17, 18, 16 and 16 officers, respectively. The following officers served concurrently as members of CORPORATION's Board of Directors:

PERSON A was the Chairman of the Board of Directors of CORPORATION from the time of CORPORATION's formation and through 1987. He was a member of the Board of Directors of TAXPAYER A from 1971 until March 24, 1987. He became President and Chief Executive Officer of TAXPAYER A in 1977 and Chairman of the Board of TAXPAYER A in 1980. He resigned as a director and as President and Chief Executive Officer of TAXPAYER A on March 24, 1987, and on April 1, 1987, he became Chief Executive Officer of CORPORATION.

PERSON B was a Director of CORPORATION from the time of CORPORATION's formation until September 25, 1987. He was a member of the Board of Directors of TAXPAYER A in 1983 and served in that capacity through 1987. He was named Vice President and Chief Financial Officer of TAXPAYER A in 1977 and was Treasurer from 1975 until 1986. He was named Corporate Vie President, Finance and Control, of TAXPAYER A in 1984.

PERSON C was a Director of CORPORATION in 1983 and again from December 1, 1986 through September 25, 1987. He was elected as a member of the TAXPAYER A Board of Directors in 1982, became Vice Chairman of the Board of TAXPAYER A in 1986, and was elected Chairman and Chief Executive Officer of TAXPAYER A effective as of March 24, 1987. He served as Vice President, Planning, of TAXPAYER A from 1979 until 1983. He was named Vice President, Polypropylene, in 1983 and later that year became Division Vice President, TAXPAYER.

PERSON D was a Director of CORPORATION from December 1, 1986 through September 25, 1987. He was named General Counsel of TAXPAYER A in 1976 and served TAXPAYER A in that capacity through 1987. He was named Vice President and General Counsel of TAXPAYER A in 1982.

PERSON E was a Director of CORPORATION from 1984 through 1986. He was elected as a member of the TAXPAYER A Board of Directors in 1981 and held the title of Divisional Vice President of International Operations. He was named Senior Vice President of TAXPAYER A in September, 1989. He held this position until his retirement in the first quarter of 1992.

Stip.61

43. On February 12, 1987, CORPORATION sold approximately 22.6% of its stock at $28.00 per share in a public offering. Upon completion of the sale, TAXPAYER A and TAXPAYER B each owned approximately 38.7% of CORPORATION's issued and outstanding stock. Stip.64

44. On September 15, 1987, TAXPAYER A sold all of its common stock in CORPORATION to TAXPAYER B for $59.50 per share Stip.66; Ex.12; Ex.13

45. TAXPAYER A used approximately 33.7% of the proceeds from the sale of its stock in CORPORATION to pay taxes resulting from the sale, 35.6% to redeem shares of its own stock, and 30.7% to fund additional investments in research and development in the aerospace and film businesses and to pay for the upgrading of facilities across the country. Stip.67

Conclusions of Law:

The issue presented concerns the determination of the proper income reportable by TAXPAYER A for the tax year ending December 31, 1987, *i.e.*, was the capital gain realized upon the sale of TAXPAYER A' interest in CORPORATION business income apportionable to Illinois?

If the income is classified as business income, it is apportionable under 35 ILCS 5/304(a) and includible in Illinois taxable income. If it is nonbusiness income, it is allocated to TAXPAYER A' commercial domicile in Delaware under 35 ILCS 5/301(c)(2)(B).

Illinois Administrative Code, Ch.I (hereinafter Regulation or Reg.) Sec. 3010(a) further provides that a person's income is business income unless it is clearly classifiable as nonbusiness income. Nonbusiness income means all income other than business income.[1]

The Illinois Income Tax Act, at 35 ILCS 5/1501(a)(1), defines business income as:

> . . . income arising from transactions and activity in the regular course of the taxpayer's trade or business, net of the deductions allocable thereto, and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

This section establishes two tests — the transactional test and the functional test. The transactional test is derived from the first clause of the regulation above — income arising from transactions and activity in the regular course of the taxpayer's business. The functional test is derived from the second clause of the regulation — whether the property disposed of was used as an integral part of the taxpayer's regular course of business. If either test is satisfied, the income is business income.[2]

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[1] See also 35 ILCS 5/1501(a)(13)

[2] See Dover Corporation v. Department of Revenue, No.1-93-3340, Fifth Division, March 31, 1995); National Realty and Investment Company v. Department of Revenue, 144 Ill.App.3d 541, 554, 494 N.E.2d 924 (Second Dist. 1986). See also 86 Ill.Admin.Code Ch.1, Sec 100.3010(c)(4)(C).

(The Taxpayer's focus on unitary relationship is misplaced.) It is well-established that companies need not be engaged in a unitary relationship in order for income to be business income subject to apportionment.[3] The Court emphasized that although the existence of a unitary relationship is one means of meeting constitutional requirements, and although that might have been the focus of other cases, it is not a general requirement. What is required, rather, is that the transaction serve an operational rather than an investment function. The income may be excluded from the apportionment formula only if the income was in earned in the course of activities unrelated to those carried out in this state.)[4]

The record indicates that the transactional test has been satisfied. TAXPAYER A had been in the business of manufacturing and marketing polypropylene resins. The spin-off of its polypropylene operations to a joint venture with TAXPAYER B was not a complete divestiture of such operations and remained operationally connected to TAXPAYER A for the entire time TAXPAYER A retained an interest in CORPORATION.

One consideration deemed relevant by the Taxpayer is the frequency or regularity of similar transactions and the subsequent use of the income generated from the sale.[5] First, courts have held that the extraordinary nature or infrequency of the transaction is irrelevant.[6] Therefore, there is no significance to the fact that the sale was under coercion or "at the point of a gun."[7] Second, even if the nature of the sale were relevant, the Taxpayer's argument that the formation and disposition of its interest in CORPORATION was an extraordinary transaction is not supported by the record. The formation of CORPORATION was a transaction in the regular course of the business activities of TAXPAYER A, evidenced by the fact that it was one of a succession of at least twenty joint ventures which contributed to its unitary business.[8] TAXPAYER A regularly engaged in such joint venture transactions as the one subject herein, constituting a systematic and recurrent business practice.

In and prior to 1983, the management of TAXPAYER A considered the disposition or repositioning of its polypropylene resin manufacturing division, the CENTER. S. PERSON D, Vice President and General Counsel of TAXPAYER A, testified that TAXPAYER A had

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3 Allied-Signal, Inc. v. Director, Division of Taxation, 504 U.S. --, 112 S.Ct. 2251, 2263 (1992), citing Container Corporation of America v. Franchise Tax Board, 463 U.S. 159, 180 (1983)

4 Allied-Signal, Inc. v. Director, Division of Taxation, 504 U.S. --, 112 S.Ct. 2251 (1992), citing ASARCO Inc. v. Idaho State Tax Commission, 458 U.S. 307 (1982) and F.W. Woolworth v. Taxation and Revenue Department of New Mexico, 458 U.S. 354 (1982) and Exxon Corp. v. Wisconsin Dept. of Revenue, 447 U.S. 207, 223, 100 S.Ct. 2109 (1980).

5 See Union Carbide Corporation v. Huddleston, 854 S.W. 2d 87 (1993).

6 Atlantic Richfield Co. v. Colorado, 601 P.2d 628 (1979); Sperry & Hutchinson Co. v. Department of Revenue, 270 Ore. 329, 527 P.2d 729 (1974).

7 Tr., pp.67-74; 130

8 ". . . fulfilled another primary goal for the group" (Stip. Ex. No. 15, p.22) "Further expansion into Asia is anticipated in the next few years as TAXPAYER A identifies industry needs and develops the products to serve them." (Stip. Ex. No. 16, p.10) Involvement in the control equipment business was initiated with . . . the formation of the Canadian joint venture, Devron-TAXPAYER A . . . ." (Stip. Ex. No. 18, p.11) "The joint-venturing provides marketing and manufacturing advantages to both partners that will extend the profitable life of the business." (Stip. Ex. No. 20, p.26)

a number of discussions as early as 1978 regarding the disposition of the polypropylene resins operations.[9] He further testified that after its formation, discussions were held regarding the disposition of TAXPAYER A' share in CORPORATION.[10]

TAXPAYER A itself describes the formation and operation of CORPORATION in its annual reports:

The formation of CORPORATION, the polypropylene joint venture with TAXPAYER B, culminates the restructuring of TAXPAYER A to reduce its exposure to petrochemical commodities.

(1983 Annual Report, Ex.16, p.2)

In December, 1985, TAXPAYER A Incorporated and TAXPAYER B, announced the combining of assets to form a new joint venture to manufacture and market polypropylene fiber and film in Europe, bringing together the leading technologies, marketing capabilities, and management expertise to create a strong business presence in Europe. At the same time, it allows the rationalization of production among various facilities, and "sourcing" from whichever location makes the most sense economically at any given time.

(1985 Annual Report, Ex.18, p.20)

In addition, our assets in the European film business were contributed to a 50-50 joint venture with TAXPAYER B . Although the short-term effect of forming this venture reduced the 1986 reported sales dollars, it reinforces our commitment to regard film as a worldwide business.

(1986 Annual Report, Ex.19, p.22)

Most significant is the statement in the 1987 Annual Report (Ex. 20, p.26):

The sale of CORPORATION represents TAXPAYER A' substantial and highly profitable disengagement from the polypropylene resins business. From the early eighties, TAXPAYER A' primary objective for polypropylene resins was the enhancement of its value, for ultimate disposition. The formation of the CORPORATION joint venture during 1983 brought technical and marketing advantages to the business and the final step of taking CORPORATION public (in February of 1987) allowed the markets to value our accomplishments, paving the way for a negotiated sale of our remaining interest. TAXPAYER A' efforts over the years on disposing of this major element of the company, (which no

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9 Tr., pp.79-82

10 Tr., pp.144-146; 175-177

longer fits into strategic plans) paid dividends in terms of profit and financial resources. The financial resources provided will enhance expansion into value-added, growth-oriented areas of the chemical industry.

The language in these annual reports does not evince passive investments; it does not evince "at the point of a gun." To the contrary, the quotes indicate that these were long-term corporate strategies with specific business purposes, being furthered by their operations and continuing relationship. PERSON F, former Vice President and Chief Financial Officer of CORPORATION recognized the synergy and continuing relationship between TAXPAYER A and CORPORATION:

Q. The formation of CORPORATION resulted in both operational benefits to TAXPAYER A from a product point of view as well as a successful investment of their contribution of their assets, their business of manufacturing polypropylene to CORPORATION?

A. That is correct, and it's quite normal whenever a company seeks to improve the performance of its products, one of the first things you do is you attempt to find a strategic alliance that enables you to retain an interest in the whole process rather than just the back end, which is the benefit of improving your own products that remain, so the strategic alliance route is one that most smart corporations would take before going to a stranger to develop similar materials. (Emphasis added)

Tr.pp.295-296

The Taxpayer argues that CORPORATION was a much different company from that which was contributed by TAXPAYER A and TAXPAYER B. CORPORATION earned $226.9 million in 1987 while TAXPAYER A lost $11 in its polypropylene resins business in 1982, the last full year before TAXPAYER A contributed that business to CORPORATION.[11] The technology that TAXPAYER B contributed was superior; its plant design was better. These facts cannot be denied. But it is obvious that despite TAXPAYER A' losses, its outdated technology and manufacturing facilities, it had something significant to contribute to the joint venture. Afterall, TAXPAYER A was not asked to contribute its business to CORPORATION out of charity or altruism. TAXPAYER A was able to maximize the utilization of its obsolete business assets, *i.e.*, the polypropylene resins operations, by combining with the advanced technology of TAXPAYER B. This, combined with TAXPAYER A' sales and marketing expertise, resulted in CORPORATION's production of polypropylene with a wider set of properties. Without this combination, TAXPAYER A alone would not have been able to achieve the same results. Therefore, in addition to

[11] Taxpayer Brief, p.3

the potential profit to be generated from CORPORATION, TAXPAYER A, as a customer of CORPORATION, was clearly able to reap benefits from the enhanced polypropylene produced.[12] Tr.pp.287-299

The record clearly establishes that the formation and disposition of joint venture holdings was neither unusual nor unforeseeable. TAXPAYER A regularly and systematically acquired and divested joint ventures in an attempt to strengthen its business. The divestiture of its polypropylene resins operations had been discussed by TAXPAYER A for a considerable time. Operational benefits accrued to TAXPAYER A from the formation to the divestiture of its interest in CORPORATION, such strategies being a common practice and in the regular course of business as an effective means of utilizing it business assets.

The income also clearly meets the functional test which is derived from the second clause of the regulation — whether the property disposed of was used in the course of the taxpayer's regular course of business. Under the functional test, income from the sale of assets will be considered to be business income if the assets produced business income while owned by the taxpayer, *i.e.*, was the property ever used by the Taxpayer in its regular trade or business operations?[13] This property undeniably was used for such purposes.

To reach this conclusion, the issue cannot be viewed simply as a sale of stock. CORPORATION was established less than four years prior to the subject transaction with the transfer by TAXPAYER A of its entire polypropylene resins operations. The polypropylene resins operations of TAXPAYER A had been an integral part of its unitary business - all of the business operations of TAXPAYER A were included in the unitary business group from 1982 through 1987.[14] In 1981, TAXPAYER A sold $429 million of polypropylene resins to outside customers plus $88 million to TAXPAYER A itself. The total of polypropylene resin sales constituted approximately 18% of TAXPAYER A' total sales for that year.

The formation of CORPORATION was effected by the transfer of the polypropylene resins operations from TAXPAYER A and TAXPAYER B. The transfer to CORPORATION included not only fixed assets (equipment and plants) but the entire supporting infrastructure of the on-going business operations in the form of management and administrative services including key officers and employees, marketing expertise, contracts, goodwill, patents and technologies. CORPORATION continued to rely on TAXPAYER A' computer hardware, computer software systems, accounting systems, tax compliance services, accounts payable and receivable systems, general ledger and payroll systems, assuring continuity and stability. According to extensive testimony, CORPORATION could have functioned without the service contracts with TAXPAYER A.[15] But the salient fact is — it didn't.

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[12] In Dover, *supra*, note 2, the Taxpayer licensed patents in foreign markets which it chose not to serve, allowing the unitary group to benefit from the technology developed in unserved markets without exposure or presence in those markets. The court held that ". . . Dover has failed to establish that the patents generating the income were not held or created in the regular course of business operations or that the purpose of developing and acquiring the patents was not integral to its business operations."

[13] National Realty and Investment Company v. Department of Revenue, 144 Ill.App.3d 541, 554, 494 N.E.2d 924 (Second Dist. 1986); Dover, *supra*, note 2.

[14] Tr., p.46

[15] Tr., pp.62-63; 246-250, 303-315. PERSON F (former Vice President and Chief Financial Officer of CORPORATION) testified that CORPORATION benefitted from the intercompany services provided by TAXPAYER A. The TAXPAYER A personnel were familiar with the CORPORATION business and did not have to learn CORPORATION's business in order to perform their services, permitting

In addition, TAXPAYER A and TAXPAYER B cooperated with CORPORATION in development of a new accounting system for CORPORATION.[16] CORPORATION also selected ACCOUNTING FIRM, the same firm used by TAXPAYER A, as their corporate accounting firm.[17] CORPORATION also benefitted from its continuing relationship with TAXPAYER A by taking advantage of a volume discount through a joint purchase of computers.[18] Therefore, although it is argued that CORPORATION was a much different company from both TAXPAYER A and TAXPAYER B,[19] this does not belie the presence of functional integration.

Therefore, while there was a transfer of the entire polypropylene resins operations to CORPORATION, the transfer did not constitute a complete divestiture of the assets. Rather, the transfer resulted in a change in the form of ownership and management of the operations. Instead of owning 100% of its own polypropylene resins operations, it retained indirect ownership of the assets through its 50% interest in CORPORATION.

Although not exercising direct control, CORPORATION was not the discrete business enterprise described by the Taxpayer. From 1983 through 1987, TAXPAYER A maintained contractual and managerial connections with CORPORATION. Both before and after the formation of CORPORATION, TAXPAYER A had to purchase polypropylene resins for its own use. From 1981 forward, TAXPAYER A continued to increase its purchases of polypropylene resins — $88 in 1981 from its own CENTER; and $117 in 1984, $117 in 1985, $121 in 1986 and $142 in 1987 from CORPORATION. TAXPAYER A was one of CORPORATION's largest customers, accounting for about 12% of CORPORATION's total sales. Approximately 80 to 85% of TAXPAYER A' total polypropylene resin requirements were supplied by CORPORATION pursuant to the CORPORATION Stock Offering Prospectus. CORPORATION was, obversely, assured of a market.

The continuing relationship between TAXPAYER A and TAXPAYER B is further evidenced by the CORPORATION Shareholders Agreement, under which TAXPAYER A was obligated to purchase all of its polypropylene resins requirements from CORPORATION.[20] Although the Taxpayer describes particular provisions of the Agreement as "arm's-length,"[21] they, in fact, provide otherwise. The Agreement provided the terms of such intercompany purchases of polypropylene from CORPORATION:

> The basic principle for the sale of (CORPORATION) products to either the (TAXPAYER A) or (TAXPAYER B) Group polypropylene resin consuming units shall be that the transfer will take place at market price, less a discount intended to recognize the fact that selling and other indirect expenses will be less for sales to the parents of the venture than that incurred in the open marketplace.

CORPORATION's management to focus on other matters. PERSON D testified that it was a benefit to CORPORATION since TAXPAYER A was already familiar with the needs and services and it saved learning time. It is noted that TAXPAYER B's systems were also implemented concurrently by CORPORATION where appropriate.

16 Tr., pp.300-303

17 Tr., pp.299-300

18 Tr., pp.308-309

19 Taxpayer Brief, p.4. The value of TAXPAYER A' investment in CORPORATION increased dramatically from 1983 to 1987.

20 Sec. 10 of Stip. Ex. No. 5

21 Taxpayer Brief, pp.53-58

To this end, the following procedures will be used to determine the transfer price.

> (1) For products consumed by the (TAXPAYER A) or (TAXPAYER B) Groups which are sold by (CORPORATION) in the open market in similar quantities, the venture price . . . will be the actual net sales price . . . in the open market less 2.5%.

Exhibit 1(a) of Ex.5

TAXPAYER A was further protected from price fluctuations pursuant to the sales agreement between TAXPAYER A and CORPORATION:

> If at any time during the existence of this Agreement, a bona fide lower price for any material of like quality is offered (TAXPAYER A) by any responsible vendor on the undelivered portion, and if (TAXPAYER A) fully informs (CORPORATION) of such lower price, then (CORPORATION) shall meet such lower price or allow (TAXPAYER A) to purchase the material elsewhere while such lower price continues in effect.

Paragraph 2 of Ex.2

The prior supply agreements between TAXPAYER A and CORPORATION also contained a similar price protection provision which assured TAXPAYER A the lowest market rate price.[22] These provisions further indicate how the relationship between TAXPAYER A and CORPORATION continued after the formation of CORPORATION, enabling TAXPAYER A to enhance its position by this substantial flow of value from CORPORATION.

In addition to the supply provision in the Shareholders Agreement, the Agreement also provided for the division of CORPORATION's administrative functions between TAXPAYER A and TAXPAYER B. The primary responsibility of the operation of CORPORATION, worldwide, would be vested in its President, who would be its chief operating officer. For the first five years, TAXPAYER A would select and, if appropriate, dismiss the President. Key officials of CORPORATION and its subsidiaries would be selected by the President. The Vice Presidents for Financial Accounting and Administration would be nominated by TAXPAYER A, as would the head of the North American operations. During the first five years, TAXPAYER A would select the Chairman of the Board of Directors; during each succeeding three year period the selection of the Chairman and Vice Chairman would rotate between TAXPAYER A and TAXPAYER B.[23]

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[22] Taxpayer Brief, p.53; Stip. Ex. No. 7

[23] Stip.56; Stip. Ex. No. 5, pp.13-16

At the time of the initial formation of CORPORATION, both TAXPAYER A and TAXPAYER B appointed 3 Directors to CORPORATION's 6 member Board of Directors. The functional integration of the companies was enhanced by the fact that during 1983-1987, a number of officers of TAXPAYER A served concurrently as members of CORPORATION's board of Directors. PERSON A was Chairman of the Board of both TAXPAYER A and CORPORATION from 1983 through 1987 and simultaneously was the President and Chief Executive Officer of TAXPAYER A.[24] There were never deadlocks as to any matters brought before the Board.[25]

TAXPAYER A and CORPORATION were also functionally integrated pursuant to service contracts.[26] The scope of the services are described as:

> . . . general management and administrative services and advice customarily supplied by executive and staff departments of a company in the chemical industry, including, but not limited to, service and advice on corporate, operating, accounting and financial matters. The types of services to be provided hereunder include, among others, those currently provided by TAXPAYER A' Advertising and Public Relations, Comptroller's, Engineering, Law, Information Resources, Medical, Personnel, Purchasing, Safety, Tax and Audit and Treasurer's departments with respect to its own business and affairs.[27]

These services continued during the period 1983 through 1987.[28] Generally, TAXPAYER A cooperated with CORPORATION in providing whatever services CORPORATION ordered.[29] Pursuant to the agreement, CORPORATION paid from $9.4 to $9.9 million dollars per year for such services during this period. The amounts paid for these services are described as *de minimus* by the Taxpayer;[30] but the value of the benefit and efficiency of this arrangement to CORPORATION cannot be measured. Although CORPORATION could have purchased the services from other sources, TAXPAYER A was already familiar with CORPORATION's needs and capabilities, being familiar with the operations from their association prior to the formation of CORPORATION. This obviously shortened the start-up time, saving considerable time and money for CORPORATION during its formative years.[31]

The functional integration of TAXPAYER A and CORPORATION was further benefited by the proximate locations of the TAXPAYER A and CORPORATION facilities after the formation of CORPORATION — CORPORATION maintained its headquarters in the

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24 Stip.54, 61
25 Tr., pp.134-135
26 Stip. Ex. Nos. 8 and 9
27 Stip. Ex. No. 8, p.1
28 Tr., p.311
29 Tr., p.135
30 Taxpayer Brief, pp.61, 68
31 Tr., pp.61-63; 103-105; 152-153; 244-248; 315-319

TAXPAYER A facility for from 1983 through 1987. This situation facilitated the furnishing of services by TAXPAYER A to CORPORATION and translated into economic benefits to both TAXPAYER A and CORPORATION.[32]

The assets transferred to CORPORATION were integral parts of TAXPAYER A' business and remained so until the sale of its joint venture interest. CORPORATION was not operated as a discrete business — the record indicates extensive functional integration between TAXPAYER A and CORPORATION. The business activities of CORPORATION were operationally connected to TAXPAYER A' unitary business activities for the entire period. Not until TAXPAYER A' disposition of its interest in CORPORATION in 1987 was TAXPAYER A' connection with CORPORATION completely severed. It was only at that time that TAXPAYER A realized the full gain from the divestiture of the polypropylene resins operations — a disposition which began in 1983 as a step in the restructuring of TAXPAYER A.[33] And it was not until 1987 that there was a full divestiture of TAXPAYER A' connection with the operations of CORPORATION.

The Taxpayer further argues that since TAXPAYER A had no manufacturing facilities in Illinois, and its business in Illinois was exclusively marketing its industrial chemicals which were manufactured elsewhere, the profit margin generated solely by TAXPAYER A marketing operations in Illinois is unrealistic and out of proportion to TAXPAYER A business operations in Illinois.[34] If that is the case, this argument is irreconcilable with the fact that the polypropylene resins division was always considered by the Taxpayer to be a part of its unitary business group. The nature of the polypropylene resins operations was not modified in Illinois after the formation of CORPORATION, so the argument that the numbers are out of proportion is erroneous. The Taxpayer's argument that by including the CORPORATION gain in business income, the Department has attempted to increase TAXPAYER A' Illinois income by over 3,500%[35] is also without merit. To paraphrase the Illinois Supreme Court,[36] it proves nothing to say a 3,500% increase of tax liability is excessive. Disparity, distortion — if the Taxpayer's calculation is incorrect, the percentage increase is irrelevant.[37]

The sale of the CORPORATION stock represents the completion of the long-term strategy of TAXPAYER A to divest itself of the polypropylene resins business. There was a significant flow of value between TAXPAYER A and CORPORATION — TAXPAYER A purchased product from CORPORATION, provided services to CORPORATION, and exercised control over CORPORATION's operations — indicating that CORPORATION was not the discrete business enterprise described by TAXPAYER A. It is, therefore, recommended

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32 Stip. Ex. No. 11, pp.22, 26, 32, 36 and 58. As an example, TAXPAYER A and CORPORATION's combined consumption of electricity provided a lower cost to both.

33 See pp.16-20, *supra*, for a more complete discussion of the corporate strategy.

34 Taxpayer Brief, p.78

35 Taxpayer Brief, pp.109-112

36 Citizens Utility Company of Illinois v. The Department of Revenue, 111 Ill.2d 32, 53 (1986).

37 Carried to its "logical" extreme, what if a taxpayer showed no tax due (no nexus) and the Department of Revenue determined that one of the companies in the unitary business group had nexus in Illinois and that the group would be taxable in Illinois, would the taxpayer argue that the percentage increase in tax (from zero to $100) was out of proportion?

that a final decision be issued consistent with the determinations memorialized above and that the Notice of Deficiency be sustained in its entirety.

Harve D. Tucker
Administrative Law Judge

Date